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424230—57

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 868

BEAVER PIPE TOOLS, INC., PETITIONER

v.

THOMAS M. CAREY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 69a–71a)[1] is reported at 139 F. Supp. 470. The opinion of the Court of Appeals (Pet. 23) is reported at 240 F. 2d 843.

JURISDICTION

The judgment of the Court of Appeals was entered on January 4, 1957. The petition for a writ of certiorari was filed on March 29, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

[1] References designated "R." are to the record printed as the appendix to taxpayer's brief in the Court of Appeals.

QUESTION PRESENTED

Whether the record warrants the District Court's conclusion, affirmed by the Court of Appeals, that "8% Preferred Debentures" issued by taxpayer corporation to its controlling stockholders evidenced capital contributions rather than bona fide indebtedness, and that consequently earnings of the corporation distributed to the stockholders as "interest" on the debentures were not deductible under Section 23 (b) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

STATEMENT

The taxpayer, Beaver Pipe Tools, Inc., an Ohio corporation, brought this action in the United States District Court for the Northern District of Ohio to recover $104,382.71, plus interest, in income and ex-

cess profits taxes for the years 1940 through 1949. (R. 7a–8a, 13a.)

For each of those years, taxpayer paid $15,360 to the holders of its "8% Preferred Debentures" from its current or accumulated earnings and profits. It deducted such amounts as interest in computing its taxable income. The Commissioner of Internal Revenue disallowed such deductions and assessed the resulting deficiencies, which were paid prior to commencement of the action. (R. 16a–19a, 63a.)

During the time here material, taxpayer was controlled by two related families which owned over two-thirds of its stock. (R. 20a, 23a, 26a.) In October 1936, taxpayer had outstanding 1,920 shares of 8% cumulative preferred stock having an aggregate par or stated value of $192,000 and 8,000 shares of common stock having a stated value of $8,000. (R. 14a–16a.) In December 1936, taxpayer's directors authorized the issuance of $192,000 in principal amount of "8% Preferred Debentures to be used solely for the purpose of exchanging the same for preferred shares in the company * * *." (R. 37a.) The exchange was made at the end of 1936 and the beginning of 1937. (R. 22a.) The two families holding the controlling common stock also owned in excess of 75% of the principal amount of the 8% preferred debentures immediately after they were issued, and still held them in August 1955. (R. 20a, 23a, 24a.)

Taxpayer's purpose in issuing the 8% preferred debentures in exchange for its outstanding 8% cumulative preferred stock was stated by the board of directors as follows (R. 40a):

> One of the main reasons for the issuance of the debentures, both common and preferred, is that, in determining the net income of the Company for income tax purposes, dividends are not a deductible item, whereas interest paid upon the debentures will be a deductible item, just as any other interest.

With reference to the exchange of preferred debentures for preferred stock, the holders of the preferred stock were advised by the directors that "The Preferred Debentures contain substantially the same terms and provisions as are found in the preferred shares." (R. 37a.)

At the same time as this exchange, taxpayer declared a dividend of $15 per share on its 8,000 shares of common stock, payable out of paid-in surplus. This dividend of $120,000 was paid in taxpayer's ten-year 6% common debentures, the principal sum of which was payable on December 31, 1946. (R. 27a, 32a.) These common debentures were fully redeemed prior to their maturity date. (R. 45a.)

The 8% preferred debentures contained no fixed maturity date on which the principal amount would be payable; they were payable only upon liquidation of the company. (R. 31a.) In addition, they provided in substance (R. 28a–32a):

> 1. The rights of the holders are superior to those of the holders of the common debentures and the shareholders "but shall be junior and subordinate to the rights of all other creditors."
>
> 2. If the interest or principal becomes due and remains unpaid and if funds therefor have

not been set aside, no interest on the common debentures and no dividends are to be paid.

3. They are subject to redemption at 110% of their principal amount at "the option of the board of directors."

4. In the event of liquidation, they "immediately become due and payable" and the holders are entitled to receive the unpaid principal and interest from the assets "remaining after paying the debts and liabilities." No sale of the taxpayer's assets, reorganization, consolidation or merger is deemed to be a liquidation "unless the board of directors of the Corporation shall otherwise determine."

5. If "interest" thereon is in arrears "for a period of three years" or in the event of any other default, the principal amount becomes immediately due and payable, provided the holders of 75% of the principal amount so elect. They "may however waive any such default."

6. No holder "of less than 75% in principal amount of the Preferred Debentures shall have any right to commence suit or obtain judgment thereon."

If the preferred debentures represent borrowed capital (as taxpayer asserts) rather than equity capital, then after their issuance the debt-equity ratio of taxpayer's capital structure was approximately ten to one. (R. 59a–60a.)

When taxpayer issued the preferred debentures, the interest rate on commercial loans was approximately 3% and corporate bond yield ranged from 3% to slightly more than 4½%. The 8% yield on the preferred debentures was nearly twice the prevailing rate for loans to corporate borrowers. (R. 64a–65a.)

The preferred debentures have not been reacquired by the taxpayer.

The District Court found and held that the preferred debentures did not represent indebtedness within the meaning of Section 23 (b) of the Internal Revenue Code of 1939, and hence that the so-called "interest" paid thereon was not deductible. (R. 70a–71a.) The Court of Appeals affirmed *per curiam*. (Pet. 23.)

ARGUMENT

The question here is essentially the same as was presented in *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), in which the taxpayer's petition for certiorari was recently denied. 352 U. S. 1031. There is no more occasion for further review of this case than of that one. The issue is essentially one of fact; the decision below is correct; and no conflict exists.

1. The payments in question constituted deductible "interest" only if the "Preferred Debentures" represented genuine indebtedness as distinguished from risk capital.[2] Whether a so-called debt instrument issued by a corporation to its controlling stockholders

[2] Section 23 (b) of the Internal Revenue Code of 1939 (*supra*, p. 2) does not permit a corporation to deduct in the guise of interest on indebtedness what in reality constitutes a dividend on stock. Long-standing Treasury Regulations under Section 23 (b) provided that "[s]o-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income." Art. 23(b)–1 of Regulations 86, 94, 101, and Secs. 19.23(b)–1 and 29.23(b)–1 of Regulations 103 and 111, respectively. Under familiar principles, the Regulations are deemed to have received implied legislative approval. *Helvering* v. *Winmill*, 305 U. S. 79, 83.

does reflect a true debt—or instead merely a vehicle for the distribution of dividends—presents a question of ultimate fact in each case, depending on all the relevant circumstances and terms of the instrument. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521. The courts of appeals, including those with whose decisions taxpayer alleges conflict, have uniformly so held.[3]

After carefully weighing all of the evidence, the District Court concluded (R. 69a–71a) that the so-called preferred debentures in substance reflected a proprietary rather than a creditor interest in the corporation, and, as the court below pointed out (Pet. 23), that conclusion is amply supported by the record. The debentures lacked several important features characteristic of indebtedness, and the circumstances surrounding their issuance confirm the conclusion that they were not intended to represent bona fide indebtedness. As the Court of Appeals stated in affirming (Pet. 23): "In addition to having no fixed maturity date, the debentures in question were not issued for new capital, had a face value nearly ten times the stockholders' equity, and were junior to the claims of general creditors". Since the issue is one of fact, the concurrent findings of both courts below

[3] See, *e. g.*, *Washmont Corp.* v. *Hendricksen*, 137 F. 2d 306 (C. A. 9th); *Matthiessen* v. *Commisioner*, 194 F. 2d 659 (C. A. 2d); *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. 2d 644 (C. A. 3d); *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. A. 7th); *Wetterau Grocer Co.* v. *Commissioner*, 179 F. 2d 158 (C. A. 8th); *Earle* v. *W. J. Jones & Son*, 200 F. 2d 846 (C. A. 9th); *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904 (C. A. 10th).

are entitled to finality here. *Corn Products Co.* v. *Commissioner,* 350 U. S. 46, 51; *Comstock* v. *Group of Investors,* 335 U. S. 211, 214.

2. Taxpayer's repeated assertions (Pet. 6, 11, 17) of conflict between the decision below and decisions of other courts of appeals are without substance. The cases dealing with the general issue here presented are legion, and each turns as it must on its own particular facts. The ones cited by taxpayer, like the many others in this area, stand merely for the proposition that all the relevant circumstances are to be considered, no single factor being conclusive. That this was the approach taken by the courts below is apparent from their opinions.

The most that may be said in taxpayer's favor is that the debentures in question constituted hybrid securities bearing indicia of both debt and stock, and that conflicting inferences might reasonably have been drawn as to whether they were intended to create a debtor-creditor relationship as distinguished from a corporation-stockholder relationship. But in such a situation, as this Court made clear in the *Kelley* case (*supra*), the determination of whether the arrangement falls in one category or the other is peculiarly within the province of the fact-finding tribunal. Where as here the alleged indebtedness purportedly replaces a stock interest, has no fixed maturity date, and is subordinated to outside claims, the trial court's conclusion that the debt instrument does not evidence

genuine indebtedness cannot be said to be clearly erroneous, and the affirmance of that conclusion by the Court of Appeals was fully justified.[4]

3. There is no merit in taxpayer's contention (Pet. 17) that the District Court committed prejudicial error in excluding evidence as to the manner in which the stockholders treated the exchange in their tax returns. The proffered evidence does not bear out taxpayer's assumption that the exchange was reported as a taxable event (R. 43a–44a, 49a), but, even assuming that it does, the treatment accorded the exchange by the stockholders manifestly would not be determinative of whether the debentures are to be treated as the corporation's indebtedness. In any event, the District Court considered the proffered evidence (R. 71a), and properly declined to view it as conclusive of the issue.

Equally without merit is taxpayer's contention (Pet. 17) that the manner in which it recorded the payments in question on its books and reported them on its returns is determinative of their deductibility under the taxing statute. See *Bazley* v. *Commissioner*, 331 U. S. 737, 741.

[4] The fact that the "preferred debentures" contained substantially the same provisions, as well as the same 8% rate, as the preferred stock for which they were exchanged (R. 37a), and the fact that this rate was nearly twice the prevailing market rate on corporate loans (R. 64a–65a), lend further support to the District Court's conclusion.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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OCTOBER TERM, 1956.

No. 868.

BEAVER PIPE TOOLS, INC.,
Petitioner,

vs.

THOMAS M. CAREY,
Respondent.

REPLY BRIEF ON PETITION FOR CERTIORARI.

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REPLY BRIEF ON PETITION FOR CERTIORARI.

The Respondent in footnote 2 on page 6 of his brief refers to the doctrine of *Helvering v. Winmill,* 305 U. S. 79 (1938). Under that decision, Treasury regulations and interpretations long continued without substantial change applying to unamended or substantially reenacted statutes are deemed to have received Congressional approval and have the effect of law. Accordingly, Appeal and Review Recommendation No. 237 published by the Bureau of Internal Revenue in 1920 (3 Cum. Bull. 327) that debenture stock, the face amount of which was payable on dissolution or at the expiration of corporate existence of the issuer, is indebtedness and the interest thereon deductible, should be considered as having the effect of law on down through January 29, 1940 when for the first time a collateral contrary ruling was promulgated. This is discussed in our petition for certiorari (pages 7, 11).

The cases cited in footnote 3 on page 7 of Respondent's brief do not militate against Petitioner's position.

In *Washmont Corp. v. Hendricksen,* 137 F. 2d 306 (C. A. 9th) the holders of the certificates involved were

to share equally in earnings with the common stockholders after each had received specified dividends and upon liquidation were to participate in assets along with the common stockholders. In addition, the Taxpayer had represented to its bank that the certificates were capital stock and the bank had relied upon that representation.

In *Matthiessen v. Commissioner*, 194 F. 2d 659 (C. A. 2d) a holding that advances from time to time by petitioners to their wholly owned corporation were capital contributions was held not clearly erroneous.

In *John Wanamaker Philadelphia v. Commissioner*, 139 F. 2d 644 (C. A. 3d) preferred stock issued to a principal shareholder in payment of a debt due him, authorized by resolution of the directors and approved by the shareholders was held to be stock. Under its terms this stock was deferred to payment of the common capital stock upon dissolution, voluntary liquidation or sale of the property and assets of the corporation.

Commissioner v. Meridian & Thirteenth R. Co., 132 F. 2d 182 (C. A. 7th) involved preferred stock entitled to cumulative dividends payable out of earnings only and providing for redemption at definite maturity dates, all as authorized by the taxpayer's Articles and the statutes of Indiana.

In *Rowan v. United States*, 219 F. 2d 51 (C. A. 5th) advances by a husband and wife to their wholly owned corporation and in *Earle v. W. J. Jones & Son*, 200 F. 2d 846 (C. A. 9th) advances by the principal shareholder to a corporation owned by himself, his wife and two sons were held to constitute indebtedness; as was also the issue of so-called preferred stock in *Bowersock Mills & Power Co. v. Commissioner*, 172 F. 2d 904 (10 C. A. 1949).

In *Wetterau Grocer Co. v. Commissioner*, 179 F. 2d 158 (C. A. 8th) the instruments involved were not negotiable, the amount of "interest" was not fixed by them and its payment was not definite but dependent on earnings and at the discretion of the board.

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